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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/79



3:00 p.m., May 11, 1981

W. B. Dale, Acting Chairman

Executive Directors

Alternate Executive Directors

M. Abdollahi

L. D. D. Price

A. Buira

D. E. Syvrud
H. G. Schneider
M. Casey

R. K. Joyce
M. Finaish

H. Suzuki, Temporary
R. T. Salazar
J. R. Gabriel-Peña
V. Supinit

J. C. Iarezza
A. Kafka

S. Kiingi
G. Laske
G. Lovato

C. P. Caranicas
T. Aulagnon
A. Alfidja
D. L. Kannangara
H. G. Askari, Temporary
T. de Vries

M. Narasimham

J. J. Polak
A. R. G. Prowse
J. Sigurdsson

L. Vidvei
Tai Q.

J. W. Lang, Jr., Acting Secretary
J. A. Kay, Assistant

1. Grenada - 1980 Article IV Consultation, and
Stand-By Arrangement Page 3

Also Present

Asian Department: A. Abadjis, D. A. Scott. Exchange and Trade Relations Department: D. K. Palmer, Deputy Director; S. Mookerjee, Deputy Director; H. W. Gerhard. External Relations Department: G. P. Newman. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, J. M. Ogoola. Treasurer's Department: A. M. Al-Samarrie. Western Hemisphere Department: S. T. Beza, Deputy Director; A. I. Abdi, J. E. Gonzalez, M. E. Hardy, C. S. Lee, Y. Ozeki, S. J. Stephens, H. J. O. Struckmeyer, G. Yadav, J. E. Zeas. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, A. B. Diao, M. A. Janjua, G. Jauregui, P. D. Peroz, F. A. Tourreilles. Assistants to Executive Directors: E. M. Ainley, A. F. P. Bakker, M. J. Callaghan, M. V. Carković, A. Halevi, J. U. Holst, K. V. Jännäri, J. M. Jones, J. E. Leimone, J. S. Mair, M. Michelangeli, V. K. S. Nair, J. Reddy, M. Shadman, O. Uçer, T. H. Williams.

1. GRENADA - 1980 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1980 Article IV consultation with Grenada, together with a proposed decision concluding the 1980 Article XIV consultation (SM/81/55, 3/13/81; Cor. 1, 5/6/81; and Cor. 2, 5/7/81). They also took up a request by Grenada for a stand-by arrangement equivalent to SDR 3.425 million (EBS/81/104, 5/6/81; and Cor. 1, 5/8/81), replacing Grenada's requests for an extended arrangement and a purchase in the first credit tranche contained in EBS/81/55 (3/13/81), and Supplement 1 (3/20/81).

Mr. Casey thanked Executive Directors for agreeing to discuss the matter at short notice. Grenada had a population of about 100,000 and GDP per capita of some SDR 600. The rate of unemployment was currently about 35 per cent and was, understandably, a matter of great concern to the authorities. The service and agricultural sectors accounted for the bulk of national output; manufacturing provided for less than 5 per cent of GDP. At such an early stage of development it was not surprising that most of the investment was undertaken by government and was largely financed by foreign loans and grants. Because of the low standard of living, domestic savings were inadequate and the resource gap was large. The economy was extremely open and vulnerable to international developments. After a period of civil unrest in 1974, economic activity had recovered and remained fairly buoyant for the next five years. However, floods in late 1979 and extensive hurricane damage in 1980 contributed to a fall in real output in 1980. A high level of foreign grants in the same year had kept the overall fiscal and external accounts roughly in equilibrium, but such a high dependency on grants could not of course be sustained. Thus, the underlying balance of payments and fiscal situation was clearly a cause for concern. It should, of course, also be noted that the conventionally measured deficit was, in any case, expected to increase very sharply for 1981 as a whole.

On the institutional side, Mr. Casey went on, Grenada was a member of the East Caribbean Currency Authority (ECCA), which was a monetary union, and ECCA was developing toward becoming a central bank for the whole region. Consequently, Grenada had limited access to foreign exchange holdings. If Grenada earned inadequate foreign exchange or could not borrow abroad, there was no option but to import less. Membership in the East Caribbean Currency Authority also meant that the Grenadian authorities had limited ability to adjust interest rates or the exchange rate. Hence, any variation in the monetary aggregates was exogenous. It should also be emphasized very strongly that the balance of payments need in a country like Grenada ought to be interpreted quite differently from balance of payments need in countries that held their own reserves and that were free to move exchange rates and interest rates. In an economy like that of Grenada there would be some tendency toward equilibrium, although not in 1981, but it would be equilibrium at a low level of economic activity and at a high rate of unemployment. In such circumstances it was important to assess what the underlying balance of payments deficit would be if the economy were growing at a reasonable rate. On that basis, Grenada had a

very real balance of payments need indeed, especially taking into account the volatility and unsustainability of monetary flows and transfers.

Taking up Grenada's request for a stand-by arrangement, Mr. Casey noted that, given the institutional setting and the limited number of policies available, it was clear that any Fund program would have to concentrate on fiscal policy. It was not surprising therefore that the main performance criterion related to the overall government deficit. One of the main thrusts of the proposed arrangement was to eliminate the current budget deficit and set the stage for sizable budget surpluses on current account in subsequent years, thereby freeing resources for investment. The reduction to zero of the current budget deficit in 1981 might not at first sight appear to be a very great adjustment by comparison with 1980, when the deficit had been quite small. The adjustment should, however, be viewed against the situation that would arise in 1981 if there had been no program. On that basis it could be shown that the new fiscal measures--improvements in tax administration, and the wage deal--had had the effect of eliminating a current budget deficit which, in the absence of such measures, would have been at least 3 per cent of GDP. On the expenditure side, a more effective control system would be put in place once uniform accounting procedures were established. In addition to monitoring the pay element, further efforts would be made to ensure that state enterprises did not have to draw on exchequer finances. He personally had seen the beginnings of the new system of expenditure control in operation and had been greatly impressed. The Grenadian authorities appreciated very highly the technical assistance services rendered by the Fund, particularly with respect to expenditure control.

On incomes policy, Mr. Casey said that the Grenadian authorities were acutely conscious of the need to guard against expensive wage increases. With a fixed exchange rate, they fully realized, it was important to maintain export competitiveness by keeping costs down. The Government was close to an agreement on pay along the lines set out in the Letter of Intent. The pay increases proposed would be below the rate of inflation; they would not even compensate for past price increases. It was noteworthy that the settlements were substantially below those that the unions originally sought. Within the overall pay ceilings there would be some flexibility to attract more highly qualified personnel. The underlying concept in the pay settlements was that of the wage fund, and the settlements themselves represented a considerable degree of adjustment.

On the topic of public investment, Mr. Casey stated that one main element of the program was indeed the large increase in public investment, which was the centerpiece of the effort to bring about a restructuring of the economy. Construction work on the airport at Point Salines, which was an ideal site, accounted for much of the increase in capital outlay. A significant part of the expenditure intended for the airport in 1981 was of a contingent nature and might not be spent. In any event, the capital outlay allocated to agriculture would probably be larger. Moreover, the

"turnkey" nature of the airport project seemed appropriate to the circumstances of Grenada, and the potential for tourism in the island was very large because of the country's beauty. Fund resources were in no sense earmarked for airport construction. He had that very morning received a telex from the Minister for Finance in Grenada regarding a feasibility study on the airport. The telex concluded with the words "We feel that urgent commissioning of the economic and technical study recommended by the World Bank to provide a base for policy designed to optimize economic gains from construction and operation of the airport and ancillary facilities is important." The airport and other projects relating to infrastructure, tourism, agriculture, fisheries and agro-industry were expected to broaden the productive base of the economy, to increase the ability to earn foreign exchange and to make the economy less dependent on foreign grants.

In brief, Mr. Casey observed, for obvious reasons the stand-by arrangement in an economy like that of Grenada must focus on adjustments on the fiscal side in the first instance. Reducing the current fiscal deficit would help to release resources for investment and, at a later stage, exports. Thus, a more sustainable underlying balance of payments equilibrium would be achieved. The other major aspects of the program were wage moderation and the freeing of resources for investment. The Grenadian authorities were in broad agreement with the staff appraisal contained in SM/81/55, and they were grateful for all the services provided by the Fund.

Mr. Syvrud remarked that while Executive Directors talked a great deal about the need for adjustment and financing to go hand in hand, in practice he saw more and more financing and less and less adjustment. When Grenada's request for an extended arrangement had been placed on the agenda for March 27, 1981 (EBM/81/47), he had questioned the validity of the request on the basis of economic criteria established by the Fund. The papers presented in support of the request had indicated that Grenada's balance of payments was virtually in equilibrium in 1980; they had gone on to say that a balance of payments deficit was to arise as the consequence of a multiyear investment program, which would be completely formulated by July 1981. The paper had also stated that the objectives of the investment program were not to be achieved within the period of the extended arrangement. He had asked for a deferment of Executive Board consideration on the grounds that the request departed from the economic criterion for an extended arrangement established by the Board. The management, as he understood it, had later checked with the World Bank and had learned that a significant part of the investment program appeared to be unviable. In view of the Fund's intention to improve collaboration with the World Bank, particularly in connection with extended arrangements, and its desire to ensure the promotion of meaningful adjustment, approving that arrangement would clearly have been a mistake.

Grenada had now put forward a request for a one-year stand-by arrangement, Mr. Syvrud continued. The program, however, was merely the first year of the previously withdrawn extended arrangement, with the same

performance criteria, the same financing, and the same problems. In essence, the Executive Board was being asked to support the same investment program but, because the proposed arrangement did not come under the extended Fund facility, the staff apparently assumed that the Executive Directors could not object to the absence of a viable investment program. An extended arrangement involved important safeguards designed to preserve the revolving character of Fund resources, to ensure that steady progress was made toward sustainable external positions, and to give reasonable assurance that the proposed long-term economic strategy, to which significant Fund resources could be committed, was feasible. A massive investment program was at the center of the Government's economic efforts, and the Fund was bound to rely on the expertise of the World Bank to provide insight into its viability. The staff, however, appeared to be ignoring that advice in submitting a one-year stabilization program that was the earlier extended arrangement in everything but name. The first year of a structural adjustment effort could not be turned into a one-year upper credit tranche stabilization program merely by changing some words in a staff paper.

The program presented to the Executive Board was not a short-term stabilization effort that sought an improved external position or strengthened fiscal outturn prior to some future structural adjustment effort, Mr. Syvrud commented. In fact, the overall fiscal deficit was projected to increase in 1981 by 13 times over its 1980 level, and the current account of the balance of payments was estimated to go from near balance to a deficit of \$19 million in 1981, apparently the largest deficit in Grenada's history. As he had been unable to find any analysis of Grenada's balance of payments in the staff papers, he would be interested to know how the staff had arrived at the balance of payments projections in Table 1 of EBS/81/104.

The proposed stand-by arrangement was clearly a means of providing finance for a public investment plan designed to raise capital outlays from 13 per cent of GDP to 35 per cent of GDP in 1981 alone, Mr. Syvrud asserted. Although the staff had characterized the increase as a "stepping up" in the rate of investment spending, and as a "first stage of a more ambitious program," it was clear that the Board was being asked to approve the first year of a structural adjustment effort that should be supported by an extended arrangement and should include a viable investment program. Even if the World Bank should ultimately approve the investment plan, was the Fund not acting imprudently in agreeing to a program based on questioned investment priorities, no discernible adjustment measures, and no perceptible movement toward a sustainable external position?

During the past few months, Mr. Syvrud went on, his authorities had become increasingly concerned about the level of conditionality in certain Fund programs. He had expressed those concerns many times in Executive Board meetings. The present program was, however, particularly objectionable because it provided for no apparent adjustment, its main feature had not been endorsed by those with the capacity to analyze it properly, and it clearly required an extended Fund facility framework in which to judge its long-term strategy. He would therefore abstain from approving the request.

The request posed an important issue for the Executive Board, Mr. Syvrud considered. How could Executive Directors distinguish adjustment programs that met Fund criteria from straightforward development financing, which was more appropriately financed by the development banks or other sources? In his view, an adjustment program supported by the Fund should have as its objective to put the member into a sustainable balance of payments position at the end of the program period, so that a member could continue to finance its development efforts through other sources. His authorities were especially disturbed by the manner in which the staff had contravened the traditional, established procedures of the Fund in both the substance and presentation of the request. They were likely to oppose any future request that bore any similarity to the present one.

Mr. Casey asked whether it would not be proper for Executive Directors to confine their remarks to the request for a stand-by arrangement. The request for a drawing under the extended arrangement had been withdrawn.

The Acting Chairman explained that the substitution of a request for a stand-by arrangement for a request for an extended arrangement was the result of further discussion with the Grenadian authorities. Nevertheless, the tradition of open discussion in the Executive Board indicated that it would be wrong to preclude remarks on the background to the request for a stand-by arrangement.

Mr. Syvrud commented that the Fund's surveillance exercise had an evolving character, and that the Fund's practices and policies evolved on the basis of case-by-case consideration of various issues. The best way to develop the Fund's policies on surveillance and conditionality was to try to draw lessons from individual cases. The purpose of the discussion was certainly not to be adverse to any particular member but to try to formulate wiser policies.

Mr. Price recalled that the present request replaced an earlier one for an extended arrangement contained in EBS/81/55 (3/13/81) and Supplement 1 (3/20/81). His authorities had been concerned that a number of recent extended arrangements had not conformed fully with the 1974 decision. In particular, they had felt that the adjustment path had not always been clearly delineated over the three-year period, and that the program had not always appeared "adequate for the solution of the member's problems," as required in the 1974 decision. In those cases, however, they had been prepared to accept the judgment of the staff and the assurances of the authorities concerned.

However, his authorities had had serious doubts about the program proposed in connection with the present request by Grenada, which in their view had represented a real departure from the 1974 guidelines, Mr. Price said. There had been, for example, no indication of the likely inflow of foreign capital and grants after 1981, even though such inflows would be essential for the success of the investment program. The current account deficit expected in 1983 had not been indicated, guidelines on macroeconomic

policies had not been agreed with the Fund, and final agreement had not been reached in the crucial area of public sector wages. On the information available, his authorities could not be convinced that the program was in the best interests of Grenada, or consistent with the purposes of the Fund.

In that light, his authorities welcomed Grenada's decision to request a one-year stand-by arrangement rather than an extended arrangement, and he could support the request before the Executive Board, Mr. Price remarked. The proposed amount was exactly the same as would have been available in the first year of the extended arrangement, together with Grenada's first credit tranche drawing. The performance criteria appeared adequate and necessarily focused on the fiscal side in the absence of an independent monetary or exchange rate policy. The quantitative ceilings on the cumulative overall deficits of the Central Government would have to be kept under close review. He welcomed the undertaking on trade and payments restrictions, and he hoped that the Grenadian authorities would give early attention to the possibility of eliminating the tax on foreign exchange transactions.

The financial program for 1981 provided the framework for Grenada's adjustment strategy, Mr. Price observed. It was encouraging that considerable improvement had already occurred in fiscal management under the previous stand-by arrangement. The rescheduling of arrears and the achievement of approximate balance in the current budget was a good starting point. It was essential to Grenada's development efforts that the progress should be maintained, and he welcomed the recognition in the Letter of Intent of the need for fiscal discipline.

On the revenue side, he endorsed the staff view that further efforts should be made to raise the public sector saving rate, Mr. Price went on. The February tax package, the increases in energy prices, and the elimination of subsidies to state enterprises were important moves in that direction. On the expenditure side, efforts to improve the financial position of the public sector enterprises should not be relaxed. Some increase in civil service salaries was probably unavoidable, and he had been pleased to learn from Mr. Casey that an agreement should soon be reached. A firm agreement was essential if government expenditure targets were to be achieved. He understood, however, that the prospects for linking civil service salary increases to performance were unfavorable.

The investment program for 1981 was certainly ambitious, Mr. Price considered. To carry it out would require efficient planning and close monitoring. The authorities were confident that foreign financing would be available, and that the investment could be implemented. He attached importance to the statement in the Letter of Intent that investment expenditure would be limited to the amount of identified financing, and that it would be enlarged only if additional foreign financing could be secured. Such an arrangement was crucial to the restoration of Grenada's international creditworthiness. He also hoped that the authorities were not neglecting the need to channel adequate finance, perhaps in the

form of bank credit, to all productive sectors. If they could adhere to the program, there was a good chance that it would set the stage for a concerted attack on the fundamental and structural problems of low growth and large unemployment.

The stand-by arrangement should provide the opportunity for a detailed assessment of longer-term investment plans, which would include a feasibility study of the Point Salines airport project, Mr. Price observed. It seemed appropriate to reassess such a central element in the investment strategy, not least to determine the likely availability of foreign financing. He endorsed the staff approach in urging the Grenadian authorities to seek the collaboration of appropriate international development agencies in their investment planning, and he welcomed the telex mentioned by Mr. Casey. If fiscal targets could be met, and if realistic investment plans and appropriate macroeconomic policies could be drawn up, Grenada would be in a much better position to come to the Fund for an extended arrangement that did conform to the 1974 decision. He wished the authorities every success in implementing the stand-by program, and supported the proposed decision.

Mr. Polak commented that the adjustment effort made by Grenada should qualify for Fund assistance, if it had financing problems that were suitable for such assistance. However, it was clear that Grenada's payments difficulties arose entirely from the sharp rise in government capital expenditure. Most of the increase was to be financed from new sources, but about one third was to be provided by the Fund. There was no indication that such use of the Fund's resources could be temporary. On the contrary, the plan for 1981 was said to be only the first stage of a more ambitious program for which Fund assistance would be asked under the extended Fund facility. The present request was the first case in his recollection where the Fund was being asked to finance a development program. Such an approach went far beyond anything intended by the decision on the extended Fund facility.

He would not blame the Grenadian authorities for negotiating such an arrangement in good faith with the staff, Mr. Polak continued; and it would be unreasonable for the Fund to turn down the truncated version of the program that had been put forward for consideration by the Executive Directors. Nevertheless, in future discussions with Grenada it should be made clear that development financing was not the task of the Fund. He wondered whether it was necessary also to make the point clear to the staff. It was true that the staff had advised the Grenadian authorities to seek the collaboration of appropriate development agencies in formulating their plan in order to ensure its success over the medium term. The staff should have added that the Grenadian authorities should approach the appropriate international development agencies for the financing of their development plan also, a matter that was outside the purview of the Fund.

Mr. Lovato observed that his authorities had had insufficient time to consider the Grenadian request in view of the late issuance of the paper.

He himself found that the Grenadian authorities had succeeded in making an improvement in their fiscal policy. On the other hand, in SM/81/55 the staff had noted that in 1980 Grenada's balance of payments had been virtually in equilibrium. It would therefore be hard to justify a request for a stand-by arrangement, since one of the fundamental requirements for a purchase from the Fund was balance of payments need. Grenada's financial needs seemed to him, as to Mr. Polak, to arise from the Government's commendable purpose of increasing its investment in order to diversify the economic structure; but the financing of such a program was outside the functions of the Fund. He would take no position on the request; and he was rather disturbed by the shortage of time allowed to Executive Directors to consider the paper before the present discussion. He hoped that the case of Grenada would not set a precedent.

Mr. Laske commented that, despite the adjustment efforts by the Grenadian authorities, the financial position could not be considered strong enough to deal with the urgent problems of the country and to justify an investment effort that would take up a large volume of external resources, which did not seem to be forthcoming in an appropriate manner.

Although the current account of the country's budget was to be in balance by 1981--an improvement over 1980 and particularly over 1978--Mr. Laske noted with particular concern that the budget did not provide for the generation of domestic savings to contribute to the large investment effort on which the authorities were embarking. What was worrying was that the increase in the investment effort was so large that adequate external resources of an appropriate sort were clearly not available; in consequence, Fund resources seemed likely to be used to finance development projects. Moreover, one of them, whose viability and feasibility had not been satisfactorily established, appeared to be taking up more than 30 per cent of the whole investment effort. While he would support the proposed stand-by arrangement, he was concerned about that particular aspect of the program.

Mr. Narasimham supported the request by the Grenadian authorities; he had been convinced that their case was an appropriate one for Fund assistance in the form of a stand-by arrangement. In the absence of an independent monetary and exchange rate policy, the authorities had clearly shown determination in their efforts to improve fiscal performance, both in respect to public sector wage policy and in terms of containing the subsidies and improving the overall public sector performance.

Some speakers, Mr. Narasimham noted, had raised the general question of whether the Fund could be considered as entering into development financing, and had insisted on the revolving character of the Fund's resources. While he could agree with the general proposition that the Fund's resources should be revolving, he noted that any structural adjustment program would lead to the reordering of investment priorities. In a developing country it would be reasonable to suppose that any investment, even if it were for structural adjustment, would either directly or indirectly cause some balance of payments strain that would need financing.

That was the rationale for combining financing with adjustment policies. He hoped that, as in the case of recent decisions for Pakistan, Bangladesh, and most recently Zambia, the Fund would continue to respond flexibly to the requirements of the non-oil developing countries as they sought to find ways of adjusting the economic structure to the difficult situation in which they found themselves.

Mr. Askari said that he could support the proposed decision. A one-year stand-by arrangement fell within the principles adopted by the Fund.

Mr. Buira commented that Grenada's external position had been precarious for a number of years, reflecting a lack of freely available foreign assets and limited access to the resources of the East Caribbean Currency Authority. Grenada had had no option but to import less, thereby restraining economic activity and employment and achieving equilibrium at a very low level of economic activity, a result that was always undesirable, but particularly so in a very small and very poor country. In 1980, Grenada's exports had suffered a decline of 27 per cent as a result of the damage caused by floods and a hurricane. Gross domestic product had declined in real terms and income per capita had fallen significantly. He therefore wondered how Grenada's balance of payments need could be questioned.

Over the past two years, the Grenadian authorities had made considerable progress in strengthening the finances of the public sector, Mr. Buira considered. Current operations had been brought into balance, and fiscal arrears had been reduced despite damage from natural causes that had resulted in unplanned additional expenditure and shortfalls in public revenues.

The Government of Grenada had shown remarkable--perhaps excessive--restraint in its remuneration of civil servants, Mr. Buira continued. Since the last increase in 1978, prices had risen by 60-70 per cent. The proposed wage and salary increases of 20 per cent in 1981 and an additional 10 per cent in 1982 and in 1983 therefore seemed modest; indeed they might fall short of what was necessary to secure agreement with the union or to retain civil servants of the necessary quality and dedication.

The program for 1981 aimed at ensuring continuing improvements in fiscal management and at securing approximate balance on government current operations while expanding investment, Mr. Buira noted. Fortunately Grenada had been able to secure foreign financing on a concessional basis from a wide range of sources for most of the investment effort envisaged.

The investment program was part of a more ambitious program that would strengthen the balance of payments through a restructuring of the economy, Mr. Buira observed. Such an arrangement seemed entirely appropriate and fully in line with the policy of seeking internal and external equilibrium, not merely through demand curtailment, for which there seemed to be little scope, but also through enhancing the productivity capacity of the economy. There were several precedents for such an approach.

Investment caused payments strains, as in the cases of Pakistan and Bangladesh. Guyana and Honduras had also been supported by an extended Fund facility in similar circumstances. It would therefore seem appropriate that the present stand-by arrangement, which he could support, should be followed by an extended arrangement as soon as the multiyear investment program was formalized.

An Executive Director had raised the question of how to distinguish an adjustment program from development financing, Mr. Buira recalled. He had suggested that the answer was that an adjustment program should put a member country in a sustainable balance of payments position at the end of the program period. That was not necessarily so; there had been many cases in which the adjustment would take longer than the life of the program--among recent ones were those of Jamaica and Turkey.

Mr. Kafka said that he too was able to support the staff's proposal.

Mr. Prowse referred to copies of an exchange of communications between Grenada and the Fund management that had been circulated to Executive Directors. He wondered whether it was proper to refer to those papers in the course of the discussion.

The Acting Chairman noted that the exchange of correspondence did not constitute an official document. The papers had simply been circulated for information. However it would not be improper to refer to them.

Mr. Prowse said that some of Mr. Syvrud's comments on the substance of the matter did justify specific responses, and he would be interested to hear Mr. Casey or the staff.

Regarding the exchange of communications, Mr. Prowse referred to the Managing Director's response to the authorities and particularly to the statement that "as soon as an adequate assessment by the World Bank is available, we will be ready to propose to the Board the transformation of the stand-by arrangement into an extended arrangement, assuming that the assessment justified this course of action." He wondered whether that statement was still the background to the present discussion. In other words, was he justified in believing that, if the Executive Board agreed to the stand-by arrangement, as soon as a favorable assessment was made by the World Bank, it would be no more than a matter of procedure to transform the stand-by arrangement into an extended arrangement?

The Acting Chairman replied that there would be nothing automatic about the replacement of a stand-by arrangement by an extended arrangement. A new negotiation would be required, and staff and management would have to be satisfied that all conditions for an extended arrangement were met, including in the present case a suitable indication from the World Bank about the economic justification for the airport project. Moreover, as some time would have passed, the Fund would have to be satisfied that suitable policy measures were in place, or were in prospect, with particular reference to fiscal and wage policies.

Mr. Alfidja noted that there was apparently still some difference of opinion among Executive Directors as to what conditionality should apply, and consequently about what would constitute a good stand-by arrangement in the first credit tranche, or a satisfactory extended arrangement. He would reserve his position; if he were compelled to come down on one side or the other, he would take the view adopted by Mr. Narasimham. As to the request put forward by Grenada, seen from the standpoint of the countries that had elected Mr. Nana-Sinkam, the program was realistic and he would support it. His position had always been to trust management and staff; after all, it was they who carried out the work on the spot, naturally in accordance with the guidelines laid down by the Executive Board.

Mr. Aulagnon stated that, although he shared some of the concerns expressed by Mr. Syvrud, Mr. Polak, Mr. Lovato, and Mr. Laske, he would support Grenada's request for a one-year stand-by arrangement, which seemed better suited to the economic situation of the country than the previously proposed arrangement. He agreed with the staff that progress in the fiscal field would be essential in order to reduce the country's dependence on foreign resources; and he welcomed the authorities' statement that they intended to complete a feasibility study of the airport as part of the preparation of an investment plan during the period of the stand-by arrangement.

Mr. Abdollahi noted that Grenada possessed an economy in transition. In view of the natural disasters encountered during the past two years, the achievements reported by the staff and the continuous effort to achieve structural adjustment were both commendable. Table 3 of EBS/81/104 clearly showed that financing for development investment did not originate in the Fund but came from other external sources. There seemed to be no evidence that Fund financing was being used directly for structural investment; he therefore strongly supported the request by the Grenadian authorities.

Mr. Schneider commented that there were circumstances in which adjustment was clearly needed, and that any structural adjustment taking a considerable time--say a year or two--would involve an investment program in order to bring about a change in the characteristics of the industrial sector. The investment, which might perhaps be carried out in conjunction with a stand-by arrangement or an extended arrangement with the Fund, would certainly have repercussions on the balance of payments because imports would be required. The Fund's resources provided as part of an extended arrangement were not earmarked. It was therefore surely extremely difficult to define the point up to which the Fund would provide financial resources, and to declare that beyond that point the Fund was financing an investment program. The demarcation was not so clear that it was possible to be dogmatic in one way or the other.

Grenada offered an outstanding example of the general point he had been making, Mr. Schneider considered. The budget for 1981 contained an ambitious investment program involving capital expenditures of \$84.1 million compared to current revenues of \$69.9 million and capital revenues of \$0.2 million. Grenada was therefore perhaps a borderline case, and

he could sympathize with the Executive Directors who had voiced some concern. However, he could support the one-year stand-by arrangement taken in isolation. The question would of course still remain as to who would finance the future investment program. The World Bank might well have to be involved together with the Fund.

Mr. Iarezza stated that he could support Grenada's request for a stand-by arrangement. Without commenting on the general issue of the need for a prior positive assessment of an investment program in connection with an extended arrangement, he would only recall the position taken by his chair during the discussion on collaboration between the Fund and the World Bank (EBM/81/61 and EBM/81/62) in the specific case under consideration. He fully endorsed the sentence on page 10 of the staff appraisal (EBS/81/104), where the staff urged the Grenadian authorities to seek the collaboration of appropriate international development agencies in the formulation of a multiyear investment plan.

The staff representative from the Western Hemisphere Department, replying to questions, dealt first with the point raised by Mr. Syvrud as to why the current account deficit of the balance of payments was expected to rise so sharply. Given the institutional arrangements in countries like Grenada, imports or, more generally, the current account balance could show larger movements in response to availability of foreign grants and loans on concessional terms. It was clear that the expected deficit in the Grenadian current account was not sustainable, and the staff had been talking to the Grenadian authorities along those lines. Mr. Price had been concerned that there had been no macroeconomic projections in the proposal for an extended arrangement; that lack had been of equal concern to the staff, and it was for that reason that the staff had specifically provided for a review clause. The staff had hoped that in the meantime the Grenadian authorities would have been able to identify not only the financing but also the magnitudes that would be required to make the projections. The investment program was so large by historical standards that there was no point in offering estimates of the projections. The staff had hoped that, on review, when the figures were available, it would be able to see whether they were consistent with the strategy of economic adjustment.

Discussing the wages scene, the staff representative explained that the latest information was to the effect that the Government had reached agreement with civil servants for a wage increase in calendar 1981 and for a 10 per cent increase in 1983. It was still trying to reach agreement on wage increases for 1982; the Government was adhering to its 10 per cent offer while the civil servants were asking for 15 per cent. For the 1981 agreement the Government had stuck to the concept of a wage fund, and negotiations with the unions were continuing to bring about differential increases within the year. The Government hoped that, having reached agreement with the civil servants, it could move toward reaching a consensus with the private sector by emphasizing profitability rather than cost of living adjustments.

The staff representative from the Exchange and Trade Relations Department noted that a number of Executive Directors had raised the question whether in the present case the Fund was perhaps moving uncomfortably close to the area of development financing as opposed to general balance of payments financing. In the circumstances of Grenada, the main focus of the stand-by arrangement had been to consolidate the progress made in the fiscal area on the one hand, and to attain a high rate of investment during the program period as a first step toward strengthening both the domestic economy and the balance of payments on the other. From that perspective, the Grenadian request was similar in many ways to other requests considered by the Executive Board.

On a more general level, the staff representative recalled that a necessary, though not sufficient, condition for the availability of Fund resources under a stand-by or extended arrangement was the existence of an actual or potential balance of payments need. Once the need had been identified, the Fund could commit its resources, and the commitment would, of course, be subject to the policies on the use of Fund resources laid down by the Executive Board. It was generally understood that there was no clear-cut line that could be drawn between development financing and balance of payments financing. Once the resources became available, it was always possible to argue that funds from a particular source had been used for a given purpose, either because they had actually been used for that purpose or because in the absence of funds the expenditure would not have taken place. That was an area in which a certain amount of judgment was involved, and the point stressed by Mr. Schneider to the effect that Fund resources were not earmarked was extremely relevant. The judgment in the present case had been that it was justifiable to support the policies that the Grenadian authorities wished to follow with Fund resources under the stand-by arrangement.

Mr. Casey recalled that in his opening remarks he had explained that, since Grenada was a member of the East Caribbean Currency Authority, there was no doubt that Fund assistance would have to focus on the fiscal side. There was perhaps what might be called a problem of visibility, in that when countries were not in the institutional situation of Grenada, Fund assistance was placed in the reserves of the central bank and was not seen to be used in the budget of the country concerned. In Grenada, however, Fund resources were visibly being channeled through the budget, because there was no other way in which they could be used.

The Fund's resources would of course help to increase productive investment in Grenada, Mr. Casey admitted, but he wondered how else the economy would increase its exports over the medium term, especially in view of the many structural difficulties. As he had understood it, indeed, it was precisely for that purpose that the extended Fund facility had been established. There seemed to him no other way in which the country could achieve a payments balance at a reasonable level of economic activity. The extent of the emphasis on the supply side did, of course, require the use of fine judgment. The Executive Board had, however, approved programs for a number of countries in which the improvement in

the underlying balance of payments deficit was to come about largely as a result of improving the economic structure and raising the volume of economic inputs. In several cases, the balance of payments had not been expected to improve until some two or three years after the conclusion of a three-year extended arrangement.

The stand-by program for Grenada did certainly imply a strong measure of adjustment, Mr. Casey observed. Balance of payments adjustments were bound to occur with a lag, but fiscal adjustment was taking place immediately. Without the program the current fiscal deficit would have been of the order of 3 per cent of GDP; with the program it was to be reduced to zero. Indeed, one third of the revenue increases would come from new tax measures negotiated with the staff. Moreover, the moderation in wage increases was very marked. It was certainly legitimate to say that the adjustments would not have occurred without the Fund's program, and certainly not to the same extent. In short, the Fund's resources were being well used. While they would certainly assist the development program of Grenada, they would also be catalyzing a marked degree of adjustment, and that was consistent with Fund policy. Like others, he recalled several similar cases in which the thrust of the Fund program had been to restore the balance of payments by improving the structure of the economy and raising the output of exportable goods. In most of the cases he had in mind, three-year extended arrangements had been granted. In any event, the Fund was surely moving toward a new emphasis on supplyside economics. As long as stabilization measures went hand-in-hand with the development effort, the Fund should have no cause for concern.

Some speakers had seemed to suggest that the question of future assistance for Grenada should be considered in a very cautious manner, Mr. Casey noted. First, it would be quite wrong to prejudge the economic situation of any country, especially a country like Grenada, which was extremely vulnerable to international developments and natural disasters. Second, Grenada, like other countries, would be unable to solve its structural problems in one year. It was precisely for that reason that the extended Fund facility had been designed to attack medium-term problems of a structural nature. Third, at least one Executive Director had urged that Grenada should abolish its foreign exchange tax on imports. He agreed that that was desirable, but such structural improvement could not be accomplished overnight. Like other adjustments it required medium-term balance of payments support.

One or two speakers seemed to have implied that the staff had been wrong in originally proposing an extended arrangement, Mr. Casey observed. He categorically rejected that suggestion. At the time that the Fund mission had been negotiating with the authorities in Grenada, the staff had had no way of knowing that the involvement of the World Bank was to become a sine qua non for extended Fund programs. He quite agreed with those who had suggested that it would be desirable for Grenada to approach other international agencies for development aid. It would be particularly helpful if Executive Directors would raise that matter with their colleagues in the World Bank and in the European Community.

Commenting in general about the Fund's attitude to countries whose economies were not the same as those of the majority of Fund members, Mr. Casey stated that he believed that the institutional setting of a small open economy like that of Grenada, which was a member of the East Caribbean Currency Authority--a monetary union--meant that the authorities had limited policy instruments available to them, unlike the authorities of most Fund members. In a universal institution like the Fund it was essential to be flexible and to apply different criteria to different situations. The analytical framework required for properly assessing an economy like that of Grenada had not yet been fully developed, although the work of a number of economists was relevant. The Research Department of the Fund should be asked to undertake a comparative analysis of economies whose structural and institutional arrangements did not conform to the norm.

Replying to Mr. Syvrud, Mr. Casey reminded Executive Directors that when Grenada had requested a drawing under the compensatory financing facility (EBM/81/47, 3/27/81) no Executive Director had called into question Grenada's balance of payments need. Mr. Syvrud had implied that Grenada's proposed investment program might not be viable; it seemed difficult to make such a judgment without closer knowledge of the facts. That the World Bank had not endorsed an investment program did not necessarily mean that the program was inappropriate. There was the more general question of what the procedure should be when a country did not invite the World Bank to pronounce on an investment project. It was hardly desirable that if an investment program did not have World Bank support, the country would automatically be rendered ineligible for an extended Fund arrangement. He was in fact rather surprised that Mr. Syvrud had abstained on the present occasion. After all, when he had originally asked for a postponement of consideration of the request under the extended Fund facility, he had said that a one-year stand-by arrangement would be much more appropriate.

Taking up a question raised by Mr. Laske about domestic savings, Mr. Casey remarked that when the current account of the Central Government's operations was in balance, there were clearly no domestic public savings. But the fact remained that without the program associated with the present request, there would have been substantial domestic dissaving, and the Grenadian authorities did intend to achieve positive domestic savings in the medium term through the budget.

In conclusion, Mr. Casey expressed gratitude to the Executive Directors, management, and staff for treating Grenada's request in a fair and objective manner. It said a great deal for the Fund that the time and energy devoted to a small country could be the same as that devoted to countries many times larger. The Grenadian authorities were of course understandably disappointed that their original request for a three-year extended arrangement could not go ahead on the present occasion; but the decision that he hoped the Executive Board was about to take would reassure them that the Fund was willing to help in a meaningful way. He greatly appreciated the unstinting efforts made by the staff.

The Acting Chairman commented that Grenada possessed a rather special set of institutional arrangements that had resulted in a transparency of financial flows that might not be present in a number of other members. For instance, the size of the current account deficit was likely to be equal to the amount of the financing available, unless of course there were to be arrears, something that all agreed was highly undesirable. Moreover, because of the particular institutional arrangements, the counterpart of the Fund's financing had to be handled through the budget because there was no other mechanism for handling it. Regarding Mr. Syvrud contention that, as part of Fund policy, the balance of payments position of a member should become sustainable at the end of a program period, whether a stand-by arrangement or an extended arrangement, while that was certainly the ideal situation, it had to be recognized that with the size and complexity of the adjustment measures that many members had to undertake, such an outcome might simply not be feasible. Indeed, in the recent staff paper on enlarged access, it had been specifically envisaged that there might be cases where a series of stand-by arrangements, or more than one single extended arrangement, might be necessary because of the length of time required for countries to achieve a sustainable balance of payments position, and the Executive Board had not rejected that possibility. While in the past the Fund had done its best to secure adjustment that would result in a viable balance of payments situation at the end of the program period, there were nonetheless cases in the more distant history of the Fund in which there had been many stand-by arrangements year after year.

On a procedural point, the Acting Chairman mentioned that it was most unusual for management to ask Executive Directors to take up a matter involving the use of the Fund's resources at such short notice. He greatly regretted that he had felt it necessary to handle the matter in that way; and he assured Executive Directors that no precedent was intended. Indeed, management would do everything possible to avoid any such situation arising in the future.

Mr. Syvrud recalled that he had asked for some deferment of the discussion on Grenada's request for an extended arrangement, to give time for further consideration because of the problems that he foresaw with it; he had never opposed the request per se. Mr. Casey had suggested that countries that were members of a monetary union were in a special position in that they had little freedom of choice with respect to interest rates or exchange rates. He himself had made that point many times with respect to the two monetary unions in Africa, and he had frequently asked for studies of the position of members who accepted limits on their choice of monetary interest or exchange rate policies. Like Mr. Casey, he would be interested in a study on the matter, and had indeed understood that one was in preparation. His comments about the Fund not financing investment programs had not been directed at Grenada. They had indeed been intended as a general comment concerning the whole range of countries in the same special situation. A number of speakers had made the point that there were no clear-cut criteria to identify those cases, and that a measure of judgment was required. All that he had been saying was that in the

judgment of his authorities the Fund had overstepped the borderline, however difficult it might be to define. It was perhaps time for the Fund to take stock and readjust its policies accordingly.

The Acting Chairman noted Mr. Syvrud's statement with respect to the study that had been requested on the properties of currency unions.

Mr. Finaish inquired whether as a general rule an Executive Director had the right to request the deferment of consideration of a request by a member that was not in his constituency.

The Acting Chairman explained that while any Executive Director had the right to place a matter on the agenda of an Executive Board meeting provided that two business days' notice was given, it was not the uninhibited legal right of an Executive Director to remove any matter from the agenda. But, on occasion, when an Executive Director requested that a matter be deferred for what appeared to be reasons that were consistent with the proper operation of the Fund's business, it was customary for management to oblige the Executive Director concerned.

The Acting Chairman made the following summing up:

In discussing the 1980 Article IV consultation with Grenada, Directors supported the broad thrust of the staff appraisal. They noted the progress made in strengthening the public finances in the recent past and stressed the importance of the continued advances in this area. An improved savings performance on the part of the public sector was seen as an essential element for the support of a program of accelerated capital formation, while allowing for a reduced reliance on foreign sources of financing over the longer term.

Directors also attached considerable importance to the pursuit of a prudent wage policy aimed at ensuring the maintenance of the competitiveness of the export and tourist sectors, and the achievement of the medium-term growth potential of the economy. Encouragement was given for the Grenadian authorities to eliminate the multiple-currency practice arising from the tax on foreign exchange as soon as it is practicable.

The Executive Board then took the following decisions:

Decision Concluding 1980 Article XIV Consultation

1. The Fund takes this decision relating to Grenada's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1980 Article XIV consultation with Grenada, in the light of the 1980 Article IV consultation with Grenada conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Grenada applies a tax of 5 per cent on most purchases of foreign exchange, which gives rise to a multiple currency practice. In view of the circumstances of Grenada, the Fund approves the retention by Grenada until May 10, 1982 of the multiple currency practice resulting from the tax on foreign exchange purchases.

Decision No. 6855-(81/79), adopted
May 11, 1981

Stand-By Arrangement

1. The Government of Grenada has requested a stand-by arrangement for the period of one year beginning May 11, 1981 for an amount equivalent to SDR 3.425 million.

2. The Fund approves the stand-by arrangement set forth in EBS/81/104, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 6856-(81/79), adopted
May 11, 1981

APPROVED: September 23, 1981

LEO VAN HOUTVEN
Secretary